VZCZCXRO3685
RR RUEHLH RUEHPW
DE RUEHIL #5139/01 3390148
ZNR UUUUU ZZH
R 050148Z DEC 07
FM AMEMBASSY ISLAMABAD
TO RUEHC/SECSTATE WASHDC 3630
INFO RUEATRS/DEPT OF TREASURY WASHDC
RUCPDOC/USDOC WASHDC
RUEHRC/USDA FAS WASHDC 4139
RHMFISS/CDR USCENTCOM MACDILL AFB FL
RUEHNE/AMEMBASSY NEW DELHI 2397
RUEHLO/AMEMBASSY LONDON 6846
RUEHML/AMEMBASSY MANILA 2901
RUEHKP/AMCONSUL KARACHI 8283
RUEHLH/AMCONSUL LAHORE 4255
RUEHPW/AMCONSUL PESHAWAR 2843

UNCLAS SECTION 01 OF 03 ISLAMABAD 005139

SIPDIS

SENSITIVE

SIPDIS

E.O. 12958: N/A
TAGS: EFIN ECON EINV PREL PK
SUBJECT: PAKISTANI ECONOMY WEATHERS STATE OF EMERGENCY

Summary

¶1. (SBU) The imposition of a state of emergency and political uncertainty has markedly affected Pakistan's ability to attract and retain portfolio investment, its exchange rate and the wholesale and retail business. There have been large outflows from the stock exchange; foreign investors have withdrawn USD200 million from the equity markets during the last two months. The State Bank has intervened twice in the inter-bank market to stabilize the exchange rate. However, other economic indicators continue to perform well. Inbound foreign direct investment crossed the one billion dollar mark in July-October, and recorded close to 4 percent growth in this period. Worker remittances are up over 41 percent in October. According to independent economists, Pakistan's central bank is not contemplating any capital or foreign exchange controls. Though Moody's and the Standard and Poor have downgraded Pakistan's outlook from stable to negative, they have maintained the investment grade for Pakistan. End summary.

Economic Policy: Business as Usual

¶2. (SBU) Imposition of the state of emergency has had no impact so far on the GOP's economic policy. There have been no policy changes, and former de facto Finance Minister Salman Shah has been appointed Finance Minister in the caretaker government to underline that it is business as usual as far as Pakistan's economy is concerned. He will remain in that position until a new government is formed after the January 8 elections. Analysts noted no capital restrictions have been imposed.

¶3. (SBU) Asad Qureshi, the State Bank of Pakistan Executive Director, told Econoff that SBP is not contemplating capital controls. It is not likely to substantially intervene in the foreign exchange market to support the rupee if foreign investors panic and head for the exits in the coming weeks. Instead, the central bank is likely to commit its foreign exchange reserves sparingly, and in a "strategic manner" to ensure orderly conditions in the exchange markets.

¶4. (SBU) In a November 25 speech, State Bank of Pakistan Governor, Dr. Shamshad Akhtar, said that Pakistan's economic prospects have remained strong despite recent political events, turmoil in the international financial markets, decreased liquidity due to the sub-prime mortgage dislocations, the depreciation of the dollar, and the surge in oil prices. Pakistan's economy has been resilient thus far to these external shocks because of its underlying financial

health and strong macroeconomic fundamentals.

¶5. (SBU) Pakistan's key economic institutions continue to function normally. Since the imposition of the state of emergency, Pakistan signed an FTA with Malaysia and also approved the much anticipated petroleum policy to stimulate exploration in Pakistan (septel). The State Bank of Pakistan (SBP) conducted a successful T-bill auction and mopped up PRs35 billion (USD 573 million) with the same cut-off yields of 9.1 percent as before, with a total participation of PRs55 billion (USD901 million). On the international bond market, investors are now demanding a higher risk premium on grounds of security and political uncertainty. The 10-year Eurobond yield (issue 06/17) rose sharply to 9.20 percent from pre-emergency levels of 8.35 percent. Local bond yields have remained largely stable, at 10.1 percent for ten year bonds.

-- -
Rating Agencies Downgrade Outlook, but Maintain Investment Grades
-- --

¶6. (SBU) Following the November 3 imposition of a state of emergency, Moody's and Standard and Poor (S and P) cut Pakistan's outlook from "stable" to "negative" - primarily driven by the negative political developments. The country's investment grades have, however, been maintained at B1 and B+ due to Pakistan's good macroeconomic performance. While these ratings downgrades are closely monitored by international investors, analysts have been quick to point out that unlike previous states of emergency imposed in 1996 and 1999, there are no restrictions on capital movements, investment, or the exchange rate. Fears that Pakistan might face a mass exodus of foreign capital and experience turmoil in the financial and foreign exchange markets have not materialized.

Remittances Surge in October

¶7. (SBU) Overseas Pakistanis sent home a record USD 580.2 million in October 2007 - up by 41.3 percent over the same period last year. This surge in remittances inflow reflects the growing confidence of expatriate Pakistanis on the current and future prospects of the economy. During the first four months (July-October) of the current fiscal year, workers' remittances stood at USD 2.08 billion - up by 26.6 percent over the same period last year.

-- ----
FDI Crosses the Billion-Dollar Mark but Portfolio Investment Drops Significantly
-- ----

¶8. (SBU) Foreign direct investment (FDI) crossed one billion-dollar mark. According to State Bank of Pakistan, foreign direct investment during July-October increased by 3.9 percent to 1.3 billion dollars. In addition, Hong Kong-based Hutchison Whampoa, and UAE-based International Petroleum Investment Co, have signed multi-billion dollar agreements for the development of a deep water container terminal and the largest refinery in Pakistan respectively, which indicates the global players' confidence on the Pakistan economy. Hutchison plans to invest USD1 billion on this project while U.A.E Petroleum Investment Company will invest USD5 billion on the refinery which will be completed by 2011.

¶9. (SBU) However, there have been large outflows from the Special Convertible Rupee Accounts (Note: These accounts represent the portfolio investment inflows converted into rupees for investment in Pakistan's stock exchanges. End note.) Over the past two months (September 7 - November 7), there was net outflow of USD188.4 million from these accounts. Outflows were USD353.9 million, while inflows were USD165.5 million. Portfolio investment declined by 31.3 percent to USD310.6 million dollars during July-October 2007, compared to the same period last year. Ministry of Finance Economic Adviser, Ashfaque Hasan Khan, blamed the large portfolio outflows on the sub-prime fallout and global credit squeeze, rather than the imposition of emergency.

¶10. (SBU) Sherani remarked that portfolio investors are watching the political situation carefully, and particularly U.S. actions. If investors believe that the U.S. will break with Musharraf, or if Bhutto boycotts elections, this could cause greater portfolio investment outflows. Any sudden, massive outflows would have serious negative repercussions on the exchange rate and on the Karachi Stock Exchange, given the estimated USD4.8 billion stock of foreign portfolio investment. Habib and Askhari bankers told Econoff that all project finance transactions are on hold until the political situation becomes clearer. They thought that pending projects would not go through until after the January 8 elections.

The Rupee Hits a Three Year Low

¶11. (SBU) The rupee hit a three year low on November 14, losing 22 paisas against the dollar due to political uncertainty. This was the first major rupee depreciation in the last three years. The outflow from the stock market caused the fall in the rupee's value. From November 12-14, there was an outflow of USD88 million from the stock exchanges. The SBP injected USD70 to USD80 million in the inter-bank market during this period to stabilize the value of rupee. The State Bank of Pakistan once again intervened in the inter-bank market to prop up the Pak rupee as it fell to a 37 month low of Rs61.30 against US dollar on November 20th. The SBP was active in the market as banks were trying to buy dollars to cover the November 19th transactions. The SBP sold dollars in both spot and forward markets. As a result, the rupee strengthened by 35 paisas and closed at Rs 61.00 per dollar on November 20th. The SBP is intervening in the inter-bank market but not aggressively, since it judges that there is only a modest imbalance between supply and demand. Ministry of Finance Economic Adviser, Ashfaque Hasan Khan, however, said that there is no pressure on the rupee and the State Bank of Pakistan is intervening in the market to expand the band in which rupee should trade following IMF Article IV consultations. (Comment: The IMF maintains that the rupee is pegged to the dollar and Pakistan needs to expand the trading band for rupee. End Comment.)

Oil Price Increases Still Manageable

¶12. (SBU) Pakistan is successfully weathering the rupee's depreciation and increases in oil prices so far. Khadim Ali Shah Bukhari at Karachi's Brokerage House, told Econoffs that the impact of oil price shock is manageable and could be funded through a mix of reserve withdrawals and external debts. Pakistan can easily raise USD4 billion while keeping the external debt-to-GDP ratio constant at 27.5% in FY2008. However, he questioned whether Pakistan's ability to fund its large and growing oil import bill is sustainable, given the recent surge in oil prices and decreases in foreign inflows.

-- ---
Auto Sales Down; mixed reports on wholesale and retail business
-- ---

¶13. (SBU) According to the Pakistan Automobile Manufacturing Association, automobile sales have slowed markedly in the first four months of the current fiscal year, increasing only 4.1 percent, compared to 32 percent 5-year compound growth rate. Sales increased 14.8 percent in October. This slowdown in sales can be attributed to high interest rates for car loans, which have increased to 16-17 percent from 7 percent in 2004.

¶14. (SBU) Reports on the effect of the state of emergency on retail sales are mixed. The Chairman of the Karachi Wholesale Grocers Association was quoted in the media as saying wholesale business has dropped by 25 percent since the October 18 Karachi bombing and November 3 imposition of the state of emergency. However, one Association member told EconOff that he could not quantify the drop

in business. He commented that retailers have stopped holding stocks due to uncertain conditions, which have slowed retail sales. The Retailers Association claims that their sales have dropped by 50 percent.

Comment

¶15. (SBU) Lingering uncertainty could slow private foreign fund inflows. If foreign inflows slow, Pakistan's large current account deficit would need to be financed at least in part though reserve drawdowns and external debt disbursements, which could, in turn, put additional pressure on the exchange rate. Pakistan's current account deficit decreased to USD 2.99 billion in July-October FY2008 from USD 3.51 billion during the same period last year. The improvement in current account balance is mainly due to increases in current account transfers and exports, which grew 10.7 percent during this period. Merrill Lynch currently expects Pakistan's macroeconomic environment to remain stable and GDP growth to remain at 6.9 percent, driven by domestic consumption. The government has also expressed confidence publicly and privately in its ability to meet its FY2008 economic targets.

¶16. (SBU) Comment continued: Despite the large stock of foreign portfolio investment in equities and their tendency to flee, foreign exchange reserve adequacy remains comfortable at this point in time. Portfolio-related outflows are likely to continue to cause stress on the rupee in the short term, at until the January 8 elections. Continued oil price increases combined with slow export growth, however, pose a greater threat to Pakistan's balance of payments. Current reserves of USD 14.7 billion will cover six months of imports. We are watching carefully to see whether the current political uncertainty begins to adversely affect the FDI and remittances inflows, which so far have discounted the uncertain conditions and continued increase. If FDI and remittances begin to drop, oil prices continue to increase, and exports are slow, then Pakistan will have to make some serious economic policy adjustments. End comment.

PATTERSON